United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-7203

To be argued by
MARK M. JAFFE

United States Court of Appeals
FOR THE SECOND CIRCUIT

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,
Plaintiffs-Appellants,

—v.—

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES and HARRY GOODKIN & COMPANY,
Defendants-Appellees.

BRIEF FOR DEFENDANT-APPELLEE HAROLD B. EHRLICH

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UNITED STATES COURT OF APPEALS
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ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,

Plaintiffs-Appellants,

-against-

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

Docket No. 75-7203

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BRIEF FOR DEFENDANT-APPELLEE
HAROLD B. EHRLICH

PRELIMINARY STATEMENT

Plaintiffs, in an action purportedly brought under § 10(b) of the Securities Exchange Act of 1934, Rule 10 b-5 thereunder and § 206 of the Investment Advisers Act of 1940, appeal from an order of the United States District Court for the Southern District of New York, granting defendants' motion for summary judgment. In dismissing the complaint, the District Court found that plaintiffs had suffered no damages compensable under the Federal Securities Laws as a result of their participation in defendant limited partnership, Fleschner Becker Associates ("FBA"), but to

the contrary had realized substantial profits. The opinion below of the Honorable Robert L. Carter is reported at 392 F.Supp. 740 (S.D.N.Y., 1975).

ISSUES PRESENTED FOR REVIEW

Although defendants moved for summary judgment on several grounds, in granting defendants' motion the District Court found it:

> "... only necessary to consider the primary contention raised by all defendants, that the figures representing plaintiffs' contributions, withdrawals and distributive shares plainly show that plaintiffs have suffered no economic injury enabling them to succeed in an action for damages under Rule 10 b-5 or Section 206." (298a, 299a)

The sole issue therefore on appeal is:

Whether plaintiffs have stated a claim for actual damages compensable under the Federal Securities Laws where they suffered no loss and, in fact, derived substantial profits from their participation in defendant partnership?

STATEMENT OF THE CASE

Plaintiffs Marjorie and Robert Abrahamson are husband and wife and former limited partners in defendant FBA, a private investment partnership commonly referred to as a "hedge fund". Plaintiffs have sued FBA, three of its general partners, defendant Fleschner, Becker and Ehrlich, and defendant Harry Goodkin & Company, the Certified Public Accountants who audited the books of FBA for the fiscal years ended respectively on September 30, 1966, 1967 and 1968.

Plaintiffs' principal claim is that defendants failed to disclose to them investments by FBA in unregistered or restricted securities. Plaintiffs allege had they known of such investments and the extent thereof, they would have withdrawn from the partnership at the earliest possible time, which they claim would have been September 30, 1968 rather than September 30, 1970 when they actually withdrew. Upon withdrawal plaintiffs' realized an aggregate net profit of $289,178 on their investment in FBA of $599,499 (111a).

On January 25, 1971 plaintiffs instituted this suit to recover the sum of $1,254,800 which they claim is the additional profit they would have received had they

withdrawn from the partnership on September 30, 1968, rather than on September 30, 1970. The complaint alleges violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(j)(b), and of Rule 10 b-5 promulgated thereunder and of § 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80 b-6. Federal jurisdiction was allegedly based upon § 27 of the 1934 Act, 16 U.S.C. § 78aa, and § 214 of the Investment Advisers Act, 15 U.S.C. § 80 b-14.

On January 25, 1974 all defendants moved for summary judgment pursuant to Rule 56 of the Federal Rules of Civil Procedure on the ground, inter alia, that plaintiffs had failed to show any actual damages compensable under the Federal Securities Laws.

On March 4, 1975, the District Court held that plaintiffs have shown no damages compensable under law and granted summary judgment to all defendants dismissing the complaint. In view of the decision of the District Court, it was not necessary to reach any of the other grounds urged in support of defendants' motion.

FACTS

Plaintiffs became limited partners of FBA (then known as the Fleschner Company) on or about July 1, 1965. They withdrew from the partnership on September 30, 1970 (129a). Plaintiff Robert Abrahamson contributed capital of $150,000 to the partnership and realized a net profit, after return of his capital contribution, of $156,097 upon withdrawal. Plaintiff Marjorie Abrahamson made an initial capital contribution of $180,000 in 1965 followed by successive contributions in 1966 of $2,652.22 and $266,947.13 in 1967 for a total of $449,499.35. Upon her withdrawal from FBA she realized a net profit, after return of capital, of $133,081.35 (111a).

Defendant Ehrlich became a general partner in FBA on October 1, 1968. He ceased to take part in the management of the partnership business on July 24, 1969 and withdrew from the partnership effective September 30, 1969. He derived no profit from his participation in FBA and, in fact, lost more than $100,000 when he withdrew (287a).

ARGUMENT

PLAINTIFFS HAVE FAILED TO SHOW ACTUAL DAMAGES COMPENSABLE UNDER THE FEDERAL SECURITIES LAWS WHERE THEY SUFFERED NO "OUT-OF-POCKET" LOSS AND RECEIVED SUBSTANTIAL PROFITS FROM THEIR PARTICIPATION IN DEFENDANT PARTNERSHIP.

This case represents still another attempt to invoke the anti-fraud provisions of the Federal Securites Laws and Rule 10 b-5 in a situation where those Statutes and Rule clearly do not apply. Fershtman v. Schectman, 450 F.2d 1357 (2 Cir., 1971), cert. denied 405 U.S. 1066 (1972).

It is the very type of "would have" case barred by Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2 Cir., 1952); cert. denied 343 U.S. 956 (1952) and Blue Chip Stamps v. Manor Drug Stores, 43 U.S. Law Week 4707 (June 9, 1975):

> "Three principal classes of potential plaintiffs are presently barred by the Birnbaum rule. First are potential purchasers of shares, either in a new offering or on the Nation's post-distribution trading markets, who allege that they decided not to purchase because of an unduly gloomy representation or the omission of favorable material which made the issuer appear to be a less favorable investment vehicle than it actually was. Second are actual shareholders in the issuer who allege that they decided not to sell their shares because of an unduly rosy representation

> or a failure to disclose unfavorable material. Third are shareholders, creditors, and perhaps other related to an issuer who suffered loss in the value of their investment due to corporate or insider activities in connection with the purchase or sale of securities which violate Rule 10 b-5. Blue Chip Stamps v. Manor Drug Stores, supra, at p. 411. (Emphasis supplied).

Plaintiffs have reaped large profits from FBA and accordingly have not shown the requisite actual damages required by § 28(a) of the Securities Act of 1934, 15 U.S.C. 78bb(a) to state a claim for relief under § 10(b) of the Act and Rule 10 b-5 thereunder. Their claim is precisely the kind rejected by this Court in Fershtman, supra.

In Fershtman, the limited partners alleged misrepresentation and non-disclosure in connection with the termination of their interest in a private investment partnership. As in this case, plaintiff limited partners, suffered no damage and rather reaped large profits, 450 F.2d at p. 1361. This Court applying the out-of-pocket rule, found no damages compensable under Rule 10 b-5 where a limited partner who made an initial capital contribution of $10,001 would have been repaid $6,600 of his capital and would have been entitled to receive $13,426 in profits on a diminishing capital balance for an average return of some 18% per annum. See also, Levine v. Seilon, Inc., 439 F.2d 328 (2 Cir., 1971).

In the instant case the District Court following the rationale of this Court in Fershtman and Levine and of the Fifth Circuit in Wolf v. Frank, 477 F.2d 467 (1973); cert. denied, 414 U.S. 975 (1973) (301a, 313a) found no actual damage compensable under the Federal Securities Laws where Robert Abrahamson made an initial capital contribution to the limited partnership of $150,000 and realized at withdrawal not only his entire $150,000 contribution but a very substantial net profit of $156,097; and where Marjorie Abrahamson was similarly repaid her aggregate capital contributions of $449,499.35 and realized a net profit of $133,081.35.

To avoid the clear impact of the actual damage requirement under § 28(a) and the absence of out-of-pocket losses here, Schaefer v. First National Bank of Lincolnwood, 326 F.Supp. 1186 (N.D. Ill. 1970); appeal dismissed 465 F.2d 234 (7 Cir., 1972) plaintiffs' on appeal assert a two-pronged theory, which cannot be deduced from the complaint and which they urged as an aside below (301a, 302a). They contend that their assent to certain changes in the limited partnership agreement as of October 1, 1968 "may be viewed" first, as some sort of "purchase" satisfying the requirements of jurisdiction and standing under § 10b and Rule 10 b-5 and,

second, as an act requiring revaluation of their capital contributions to the partnership so to create asserted out-of-pocket damage. Neither contention has any basis in law.

A. Plaintiffs' Assent to Changes in Partnership Agreement Did Not Constitute a "Purchase" for Purposes of Conferring Standing and Jurisdiction Under § 10(b) and Rule 10 b-5 Where Such Changes Were Related to the Internal Management of the Partnership and Did Not Significantly Affect Plaintiffs' Rights or Obligations.

The changes in the partnership agreement as of October 1, 1968 to which plaintiffs, as limited partners, assented involved no more than modification of the internal management of the partnership. Such assent cannot be transformed into a "purchase" so as to confer jurisdiction under the Federal Securities Laws or to accord plaintiffs standing here. In Re Penn Central Securities Litigation, 494 F.2d 528 (3 Cir., 1974); cf. Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260, 267 (S.D.N.Y. 1974).

In Penn Central, the Third Circuit considered arguments analogous to those made by plaintiffs in the instant case. The Court held that the requirement of a "purchase" under § 10(b) was not satisfied where plaintiffs

there sought to rely on various corporate changes made in connection with a reorganization of the Railroad.

The test which the Court applied was whether the reorganization was: "... in fact a major corporate restructuring requiring the same amount of investment decision by the shareholders as would a proposed merger" or rather an "internal corporate management decision" which only incidentally involved an exchange of shares. 494 F.2d at 534.

The Court concluded that the changes relied upon by the plaintiffs did not bring the reorganization within the scope of § 10(b) notwithstanding that such changes involved the issuance of new classes of stock; modifications in preemptive rights and par or stated value; changes in the classes and terms of directors; changes in certain shareholder rights and the potentially wide enlargement of the Railroad's activities through diversification. 494 F.2d at 534-539:

> "The fact of the share exchange by itself certainly does not bring the transaction within the scope of 10(b), since such a share exchange may clearly involve no more than internal corporate management. Such an exchange may accompany a stock split, a reverse stock split, creation of one or more new classes of stock, changes in par

> value of stock or similar internal corporate action. Plaintiffs contended before the district court that the reorganization was within 10(b) partly because it resulted in new classes of stock, changes in preemptive rights, changes in par value or stated value, and changes in the classes and terms of directors. Although these factors are not emphasized on this appeal, we agree with Chief Judge Lord that these changes are outside the scope of 10(b). See 347 F.Supp. at 1337-1339." Id. at 534.

Here, the changes in FBA's partnership agreement are clearly far less significant than the type of change which the Third Circuit held to be beyond the ambit of § 10(b) in Penn Central. Thus, the changes in the partnership agreement relate to the internal management of the hedge fund, i.e., salaries, charges on new contributions, withdrawals, duration of partnership etc., which effectively have been removed from the remedial scope of § 10b. Penn Central, supra, at 534.

The changes in the partnership agreement are analyzed in the brief filed herein by defendant partnership and such analysis is not repeated here. What is clear from such analysis, however, is that none of the changes substantially or adversely affected the basic rights and interests of the limited partners and certainly none rose to the level required by the test recently laid down in

Penn Central.

Under these circumstances, plaintiffs' attempted analogy to Ingenito v. Bermac Corp., 376 F.Supp. 1154 (S.D.N.Y. 1974) is wholly inapposite. In Ingenito, plaintiff herdowners, as a result of an exchange of herd maintenance contracts and a system of period payments on promissory notes were required to assume additional obligations to pay maintenance charges and to make further payments on their investment contracts. There, the Court found that such additional obligations involved the reliquishment of significant rights and held that the exchange and issuance of new notes and contracts might be viewed as a "purchase" or "sale" for purposes of jurisdiction under § 10(b). By contrast, plaintiffs in assenting to the changes to the limited partnership agreement incurred or undertook no new obligations. Most important, the character, form and cost basis of their invesment in FBA remained unchanged.

The District Court recognized the hollowness of plaintiffs' "purchase" theory and correctly concluded that they lacked standing under § 10(b) (301a, 304a).

B. Plaintiffs Have Failed to Show Damages Compensable Under § 28(a) of the Securities Exchange Act of 1934.

Even if arguendo plaintiffs' assent to changes in the partnership agreement "may be viewed" as a "purchase" for purposes of conferring jurisdiction and standing under § 10(b) and Rule 10 b-5, there is no statutory basis under § 28(a) of the Securities Exchange Act of 1934 for sanctioning the application of plaintiffs' theory of damages in the instant case so as to revalue their original capital contributions for purposes of avoiding the out-of-pocket limitation.

Plaintiffs not only received their capital intact and large profits, but concede that "... here the defendants did not obtain the plaintiffs' [alleged] lost profits". (Plaintiffs' main brief p. 37). To allow plaintiffs' theory of asserted damages under these circumstances would contravene the actual damage limitation of § 28(a) as well as the policy underlying Birnbaum, Penn Central and Blue Chip, supra, to bar the type of "would have" claim asserted here.

Plaintiffs' theory of damages should be rejected, moreover, whether asserted under § 10(b) or under § 206 of the Investment Advisers Act. The issue of whether a private

right of action may be implied under § 206 has never been decided by any Court of Appeals and the reported District Court decisions on this point conflict. Bolger v. Leventhol, Horwath & Horwath, supra, and Greenspan v. Eugene Campos Del Toro, 73-638-Civ. (S.D. Fla., May 17, 1974) (Eaton, J.; unreported opinion). Even if, however, § 206 does give rise to a private right of action, the few cases arising under that section, as the District Court noted, do not suggest that the measure of damages thereunder is any different than the actual damage limitation set forth in § 28(a) of the 1934 Act (351a, 316a).

CONCLUSION

For the foregoing reasons, the order and judgment of the District Court granting defendants' motion for summary judgment and dismissing the complaint should be affirmed.

Respectfully submitted,

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